Internal Revenue Service

memorandum

CC:TL-N-8221-87
Br1:JDMacEachen

date: AUG 21 1987

to: District Counsel, Cleveland CC:CLE

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice of May 27, 1987.

ISSUES

(1) Whether the [redacted] Reorganization Trust ([redacted] Trust) is a grantor trust. 0641.00-00; 0671.00-00.

(2) Whether the [redacted] Trust may deduct amounts of income distributed to creditors. 0661.00-00.

(3) Whether the [redacted] Trust succeeded to the tax attributes of [redacted]. 0642.08-00.

(4) Whether [redacted], ([redacted]) succeeded to the tax attributes of [redacted]. 0368.00-00; 0381.00-00.

CONCLUSIONS

(1) IRC § 671-679, the so-called grantor trust provisions, have no application to a trust arising upon confirmation of a plan of reorganization pursuant to 11 U.S.C. §§ 1101-1146. Thus, the [redacted] Trust is not a grantor trust for federal tax purposes.

(2) IRC § 661, relating to deductions allowable for amounts distributed to trust beneficaries, has no application to a trust arising upon confirmation of a plan of reorganization pursuant to 11 U.S.C. §§ 1101-1146. Thus, the [redacted] Trust may not deduct amounts of income distributed to creditors.

(3) The [redacted] Trust is a trust, a separate taxable entity for federal tax purposes. In the absence of a specific statutory

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provision to the contrary, the deductions of one taxpayer may not be taken by another. Thus, the [redacted] Trust may not avail itself of the net operating loss carryovers of [redacted].

(4) The resolution of Issue 4 has required co-ordination with other National Office functions. Accordingly, we will respond to you as soon as this issue has been resolved.

FACTS

On [redacted], [redacted], a [redacted], filed a petition for reorganization under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the [redacted]. On [redacted], the taxpayer filed its Second Modified Plan of Reorganization (the Plan). On [redacted], the Plan was confirmed, and the [redacted] Trust was created.

During the pendency of the reorganization a substantial majority of the [redacted] assets, including the [redacted] name, was sold to various purchasers. Certain assets, including those necessary to [redacted], were retained.

Upon confirmation of the Plan by the court, [redacted] transferred all real estate, fixtures, machinery and equipment, tooling, inventory, accounts receivable, contract rights, intangible property, securities, instruments, cash and other assets, properties, causes of action, claims and rights of any kind existing on the confirmation date, together with the proceeds thereof, to the [redacted] Trust. [redacted]'s articles of incorporation were amended to change [redacted]'s name to [redacted] and to otherwise reflect changes wrought by the Plan. On funding of the [redacted] Trust, [redacted] had no further obligations under the Plan.

Pursuant to the Plan, [redacted] retained certain assets, including those necessary for the [redacted].

Upon consumation of the Plan approximately [redacted]% of the common stock of the reorgainzed corporation was held by the former [redacted] shareholders, [redacted]% was held by former creditors, and [redacted]% was held by investors. Certain preferred stock was issued to the [redacted] Trust for distribution to creditors and the remaining preferred was sold to investors.

Confirmation of the Plan discharged [redacted] of all pre-confirmation debt and released it from all executory contracts. [redacted] was released from the jurisdiction of the bankruptcy court.

As noted above, the Plan provides that the [redacted] assets and the shares of [redacted] common and preferred stock to be distributed in satisfaction of creditors' claims be transferred to the [redacted] Trust. All distributions made under the Plan are to be made solely from such assets and shares. Further, all rights of [redacted] creditors to receive distributions under the Plan are limited to the distribution of assets and shares held by the [redacted] Trust.

The trust agreement provides that, subject to the retained jurisdiction of the bankruptcy court, the trustee, who was formerly the chief financial officer of [redacted], shall have control and authority over the trust assets, over the acquisition, management and disposition thereof, and over the management and conduct of the business of the trust to the same extent as if the trustee were the sole owner thereof in his own right. In connection with the management and use of the trust assets, the trustee's powers generally include, but are not limited to, the following: (1) to accept the [redacted] assets; (2) to pursue objections to claims in the proceedings for reorgainization of [redacted]; (3) to distribute the trust assets in accordance with the terms of the Plan; (4) to sell trust assets or any part thereof or interest therein; (5) to prosecute or defend all actions affecting the trust and to compromise or settle any suits, claims or demands, or waive or release any rights relating to the trust; (6) to endorse the payment of notes or other obligations of any person or to make contracts with respect thereto; (7) to purchase insurance covering the liabilities of the trustee incurred in connection with his service as trustee; (8) to appoint any officers, employees, etc. the trustee deems necessary; (9) to deposit monies in banks, trust companies or other banking institutions upon such terms as the trustee shall determine; and (10) to engage in all acts that would constitute the ordinary course of business in performing the obligations of a trustee under a trust of this type.

The bankruptcy court has the authority to appoint a successor trustee in the event of the death, resignation, incompetency or removal of the trustee. Moreover, the trust must continue until it is terminated by the bankruptcy court.

PRELIMINARY DISCUSSION

The bankruptcy petition was filed [redacted], and is, therefore, not covered by the Bankruptcy Tax Act of 1980. The Bankruptcy Tax Act provisions apply to bankruptcy cases commencing after December 31, 1980, unless there is an election made by a debtor in a case instituted after September 30, 1979, to have the provisions apply. Temporary regulations have been issued to set forth the requirements for a retroactive election of the Bankruptcy Tax Act provisions. These regulations, found at 26 C.F.R. ¶ 7a.3 indicate that the election must be made by filing a written statement with the Bankruptcy Court and securing court approval. The regulations also state that the statement and evidence of court approval must be filed with the District Director on or before November 1, 1981, and must be attached to the next income tax return filed for the debtor. We understand that no such election was made.

The tax status of a similar arrangement was considered in G.C.M. 39368, [redacted], I-270-84 (Feb. 21, 1984). In that case, the issue was whether a fund that was set aside for the benefit of creditors during a bankruptcy reorganization of the debtors was taxable as a trust under section 641. G.C.M. 39368 concluded that the fund was taxable as a trust under section 641. Further, O.M. 20074, [redacted]), addressed the question of whether the subject trust was a trust or an association taxable as a corporation, and concluded that it was taxable as a trust. Thus, the [redacted] Trust is a trust taxable under section 641.

Treas. Reg. § 1.641(b)-2(b) provides that the estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or a trust.

Section 6012(b)(3) states that in a case where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

Treas. Reg. § 1.641(b)-2(b) makes it clear that no separate taxable entity is created when a corporation is in bankruptcy and that, therefore, the fiduciary is not required to make and file a return on Form 1041 pursuant to Treas. Reg. § 1.641(b)-2(a). Moreover, section 6012(b)(3) and the regulations thereunder support the foregoing position regarding corporations by requiring that a receiver, trustee in a case under title 11 of the United States Code, or assignee, who has possession of or holds title to all or substantially all the property or business of a corporation, make the return of income for such corporation in the same manner and form required of corporations (i.e., on Form 1120 rather than Form 1041). See In re Sapphire Steamship Lines, Inc., 762 F.2d 13 (2d Cir. 1985); O.M. 19894, [redacted], I-223-84 (February 12, 1985); In re Nab Food Services, Inc., 25 B.R. 221 (1982); In the Matter of Knight's Mill, Inc., 24 B.R. 143 (1982); In the Matter of I.J. Knight Realty Corp., 501 F.2d 62 (3d Cir. 1974); Rev. Rul. 84-170, 1984-2 C.B. 245; O.M. 14707, Liability of Trustee in Bankruptcy, I-1493 (Oct. 30, 1964) and attachment thereto (page 2); O.M. 17712, [redacted], I-4345 (June 5, 1972), revoked as to issue 2 only; G.C.M. 35656, [redacted], I-110-73 (Feb. 5, 1974, July 19, 1976). Thus, prior to Plan confirmation, it is clear that the bankruptcy estate of [redacted] did not constitute a separate taxable entity.

In the instant case, however, [redacted] paid assets (primarily cash and notes) into a trust created for the benefit of the [redacted] creditors. All [redacted] debt was discharged on confirmation of the Plan, and [redacted], now renamed [redacted], was released from the bankruptcy court's jurisdiction over its affairs. As there was no longer a corporation in bankruptcy after the confirmation of the Plan, Treas. Reg. § 1.641(b)-2(b) has no further application. The [redacted] Trust is an entirely separate entity, coexisting with [redacted] following [redacted]'s discharge from bankruptcy. See, G.C.M. 39368, supra, at 9.

Section 1(e) imposes a tax on the income of every estate and trust taxable under this subsection.

Section 641(a) provides that the tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust including income which is to be distributed currently by the fiduciary to the beneficiaries and income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

Treas. Reg. § 1.641(b)-2(a) states that the fiduciary is required to make and file the return and pay the tax on the taxable income of an estate or a trust.

Section 7701(a)(6) defines the term "fiduciary" as a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

Section 6012(b)(4) states that returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of title 11 of the United States Code shall be made by the fiduciary thereof.

Treas. Reg. § 1.6012-3(a)(1)(ii) provides that every fiduciary must make a return of income on Form 1041 for each trust for which he acts if such trust has for the taxable year any taxable income, or has for the taxable year gross income of $600 or more regardless of the amount of taxable income.

Section 6151(a) provides, in pertinent part, that when a return of tax is required under this title, the person required to make such return shall, without assessment or notice and demand pay such tax at the time and place fixed for filing such return (determined without regard to any extension of time for filing the return).

Thus, it is clear that the trustee of the [redacted] Trust must make a return of tax on Form 1041 accompanied by a payment of any tax due. Bankruptcy trustees do not differ from other trustees in this regard. See generally Otte, Trustee in Bankrupty v. United States, 419 U.S. 43 (1974). While the trust will be allowed a deduction under section 642(b), the remainder of Subchapter J (sections 641 through 692) does not apply. See Rev. Rul. 78-134, 1978-1 C.B. 197.

The Trustee seeks to avoid this result by arguing 1) that the [redacted] Trust is a grantor trust taxable to the grantor; 2) that the [redacted] Trust is entitled to deductions for distributions of income under section 661(a)(2); and (3) that the [redacted] Trust succeeded to the tax attributes of [redacted]. We will now consider each argument in turn.

ISSUE 1

Sections 671-679 the so-called grantor trust provisions, are designed to tax the income of a trust to the grantor of that trust where he has retained dominion and control over the trust. Thus, the tax consequences will follow the substance, as opposed to the form, of the transaction.

Section 673 as it existed on the date the [redacted] Trust was funded, provides that a grantor shall be treated as the owner of any portion of the trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within ten years commencing with the date of the transfer of that portion of the trust.

Section 677 provides, in pertinent part, that the grantor shall be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party is, or, in the discretion of the grantor or any non-adverse party, may be distributed to the grantor, or held or accumulated for future distribution to him. Treas. Reg. § 1.677(a)-1(d) provides that a grantor is treated as the owner of a portion of a trust whose income is or may be applied in discharge of a legal obligation of the grantor.

Section 672(a) defines an adverse party as any person having a substantial beneficial interest in the trust which would adversely be affected by the exercise or non-exercise of the power which he posseses regarding the trust. Treas. Reg. § 1.672(a)-1 provides that a trustee is not an adverse party merely because of his interest as a trustee. However, ordinarily, a beneficiary will be an adverse party.

The trustee of the [redacted] Trust can be expected to argue that the trust is a grantor trust taxable to the debtor [redacted], now known as [redacted], by virtue of the fact that the trust is paying the debts of [redacted] and that any assets remaining in the trust will revert to [redacted]. Similar arguments were made in In re Donald L. Sonner, 53 B.R. 859 (1985). In that case, a creditors' trust had been established upon confirmation of a

Chapter 11 plan to liquidate certain parcels of real property. Capital gain was recognized on the sale of the properties. The question presented was whether this gain was taxable to the trustee or to the debtor. The court found the trust to be a grantor trust, and the gain thus taxable to the grantor/debtor.

The Sonner court held that the provisions of section 677 of the Code were applicable, as the distributions of the trust were a) used to satisfy the legal obligations of the debtor, and b) were not subject to the approval or consent of any party, whether adverse or not. The court relied on Stockton v. United States, 335 F. Supp. 984 (C.D. Cal. 1971), a case involving an assignment for the benefit of creditors in a non-bankruptcy context. The assignment was found to constitute a trust. As the purpose of the assignment was to pay off Stockton's continuing indebtedness, he was properly treated as the owner of the trust for tax purposes under the grantor trust provisions.

The Sonner court's reliance on Stockton and the grantor trust rules is misplaced. Stockton was not a bankruptcy case. Stockton's debt was discharged by the trust only to the extent that it was paid by the trust, while in Sonner, as in the subject case, the debtor's debts were discharged in full whether or not the debts are paid in full.

Section 1141, Title 11, U.S.C., concerning the effect of the confirmation of a plan under Chapter 11 of the Bankruptcy Code, provides that upon confirmation the provisions of a plan are binding upon all parties, including the debtor. Except as otherwise provided in the plan, all property of the debtor's estate is vested, free of all claims, in the debtor. Except as otherwise provided, the confirmation of the plan discharges the debtor from all pre-confirmation debt. In the instant case, confirmation of the Plan vested all but certain assets, including the [redacted] assets in the [redacted] Trust and discharged [redacted] of all pre-confirmation debt. See Article VI of the Plan. The trustee of the [redacted] Trust managed and distributed the transferred assets pursuant to the Plan. [redacted] continued in the [redacted] business, with no further obligations under the Plan, and was released from the jurisdiction of the court.

It was the plan confirmation with its attendant discharge of all debt that works the fundamental difference between this case and the Stockton assignment for the benefit of creditors. Plan confirmation discharged all debt regardless of the assets available to satisfy the debt. As per Article V of the Plan, creditors must look solely to the assets of the [redacted] Trust for satisfaction of their claims, and have no further claims against the debtor.

In a non-bankruptcy situation debt is satisfied only to the extent paid. There is no involuntary discharge of unpaid debt. Hence, the grantor trust provisions are applicable. In the instant case, where debt was discharged regardless of whether, or to what extent, it was paid by the [redacted] Trust, the grantor trust provisions have no application. The Sonner court failed to make this distinction and proceeded to apply the grantor trust rules to the form of the transaction, as opposed to the substance, producing a result in which income is taxable to one who, in substance, received no benefit from it. The grantor trust rules were thus turned on their head.

The application of the grantor trust rules was considered in De Pinto v. United States, 407 F. Supp. 5 (D. Ariz. 1976). At the termination of DePinto's bankruptcy some $200,000 was reconveyed to him. Plaintiff sought for himself a deduction for interest paid by the bankruptcy estate on the grounds that the bankruptcy estate constituted a grantor trust under sections 673(a) and 677(a) of the Code. With regard to the application of section 673(a), relating to reversionary interests, the court stated, at 6:

> This Court is of the opinion that one who seeks the protection of the Bankruptcy Act does so with the good faith expectation of never recovering any part of the corpus of his estate which is transferred to the trustee. Plaintiff's own admission as to the rarity of such an outcome argues against the application of this section. Invocation of the protection of the Bankruptcy Act is a step undertaken by a debtor with debts which exceed his resources. See, Hartman v. Utley, 335 F.2d 558 (9th Cir. 1964); In Re Wooding, 390 F. Supp. 451 (D. Kan. 1974). It is clear that one who honestly invokes the protection of the Bankruptcy Act does so at its inception with an honest and reasonable belief that none of his nonexempt property will be returned to him. Given this prerequisite to the seeking of the protection of the Bankruptcy Act plaintiff is not in a position to argue that he had a resonable belief that he would be revested with any portion of his property at any time.

With regard to the application of section 677(a) of the Code, relating to the taxation of a trust whose income is used to discharge the legal obligations of the grantor, the court stated, at 7:

> The crucial question is whether a Bankruptcy Trustee is "adverse" within the meaning of the statute. As in most of the tax law the Court is directed to look to substance rather than form. In examining the question of whether the trustee is "adverse", that is, independent of the grantor, one examines the trustee status and his ability to act in a manner independent of the personal wishes of the grantor. See, Brooke v. United States,

> 468 F.2d 1155 (9th Cir. 1972). A review of the status of the Bankruptcy Trustee reveals that he is truly independent of and adverse to the bankrupt. Unlike other trustees, the Bankruptcy Trustee is an officer of the Bankruptcy Court and subject to its supervision. 11 U.S.C. § 61; King v. United States, 379 U.S. 329, (1964); Pruess v. United States, 412 F.2d 1293, (1969). The Bankruptcy Trustee is elected by the bankrupt's creditors, 11 U.S.C. § 72(a). He has a duty to represent the creditors and to realize the maximum profit on the bankruptcy estate. Commercial Credit Corporation v. Skutt, 341 F.2d 177 (8th Cir. 1965). The entire purpose of the Bankruptcy Act's appointment procedure is to avoid the appointment of a trustee subservient to the bankrupt. In Re Ira Haupt & Co., 379 F.2d 884 (2nd Cir. 1967). A Bankruptcy Trustee is personally liable for a failure to properly administer the bankruptcy estate for the benefit of the creditors. Leonard v. Vrooman, 383 F.2d 556 (9th Cir. 1967), cert. denied, 390 U.S. 925, (1968).
>
> It is clear from an examination of the statutory scheme that the very nature of the Bankruptcy Act is inconsistent with the requirements of the Grantor Trust provisions of the Internal Revenue Code.

The DePinto court concluded that deductions of the bankruptcy estate may not be utilized by the bankrupt. The court's reasoning was affirmed on appeal. "Nothing in the legislative history of these provisions indicates that Congress intended for them to apply in the case of an individual bankruptcy. We so hold." DePinto v. United States, 585 F.2d 405, 407 (9th Cir. 1978). See also Rev. Rul. 78-134, 1978-1 C.B. 197, and Rev. Rul. 68-48, 1968-1 C.B. 301. Cf. Richardson v. United States, 386 F.Supp. 424 (C.D. Cal. 1974), aff'd, 552 F.2d 291 (9th Cir. 1977) and Mueller v. Commissioner, 60 T.C. 36 (1973), aff'd as to this issue, 496 F.2d 899 (5th Cir. 1974), reaching a similar conclusion with regard to unused loss carryovers under section 642(h) of the Code by a discharged debtor. Therefore, we conclude that the grantor trust provisions have no application to a trust arising upon confirmation of a plan of reorganization pursuant to 11 U.S.C. §§ 1101-1146. Accordingly, the [redacted] Trust is not a grantor trust for federal tax purposes.

ISSUE 2

Section 661(a) provides a deduction in computing the taxable income of a trust in an amount equal to the sum of the amount of income required to be distributed annually plus any amounts properly paid or credited or required to be distributed for such taxable year. Such deduction shall not exceed the distributable net income of the trust.

Treas. Reg. § 1.661(a)-2 limits the deductions allowable under section 661 of the Code to certain distributuions to "beneficiaries" of the estate. The term "beneficiary" for purposes of Part I, Subchapter J of the Code is defined in section 643 to include heirs, legatees and devisees of an estate. Creditors do not fall within this definition. See Trust Estate of Thomas Lonergan, 6 T.C. 715, 719 (1946). See also Rev. Rul. 78-134, 1978-1 C.B. 197 and Rev. Rul. 68-48, 1968-1 C.B. 301. Thus, section 661 has no application to the estate of a bankrupt.

The question of whether the estate of a bankrupt is entitled to a deduction under section 661(a) of the Code was considered in Williams v. United States, 667 F.2d 1108 (4th Cir. 1981). The court concluded that the Congress simply didn't intend the estate of a bankrupt to be treated as a pass-through entity for income tax purposes. It noted, at 1111:

> Several problems would result if individual bankruptcy estates were allowed to deduct from gross income distributions made to creditors. First, it would often be difficult to determine what amount should be deductible as distributions in a given tax year until the validity of all claims against the estate was determined. Second, I.R.C. § 662(a) requires distributees to include the amount received in their personal gross income. Thus, under the trustee's reading of § 661, creditors would have to treat as income money received from the estate that may be only a fraction of the principal debt. Finally, allowing deductions under § 661 would put creditors in a better position than they were before bankruptcy, a rather incongruous result. Before bankruptcy, the debtor must pay income taxes and then pay creditors from his net income. After bankruptcy, under this construction, the trustee could pay creditors out of the estate's gross income unreduced by taxes. These problems are sufficient to convince us that Congress never intended that individual bankruptcy estates could deduct distributions from their gross income.

Finally, as noted in Richardson v. United States, 386 F. Supp. 424, 428 (C.D. Cal. 1974), "Income is to be taxed unless specifically excluded by the Code. Deductions, on the other hand, depend strictly on Congressional provisions." See New Colonial Ice Co. v. Helvering 292 U.S. 435 (1934). Therefore, we conclude that section 661, relating to deductions allowable for amounts distributed to trust beneficiaries, has no application to a trust arising upon confirmation of a plan of reorganization pursuant to 11 U.S.C. 1101-1146. Accordingly, the [redacted] Trust may not deduct amounts of income distributed to creditors.

ISSUE 3

As noted above, the [redacted] Trust constitutes a separate taxable entity for federal tax purposes. The deductions of one taxpayer cannot be availed of by another in the absence of a specific statutory provision to that effect. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Rev. Rul. 74-175, 1974-1 C.B. 52. See also DePinto v. United States, supra; Richardson v. United States, supra; Schilder v. United States, 71-2 U.S.T.C. 87,381 (1971) and O.M. 18559, [redacted] I-406-74 (April 20, 1976) to the effect that losses sustained by the bankruptcy estate of an individual may not be deducted by that individual.

Taxpayer may argue that section 642(h) provides support for the proposition that the [redacted] Trust may use the net operating loss carry-overs of [redacted] to offset the income of the trust. Section 642(h) provides that the beneficiaries of an estate or trust may deduct a net carryover loss upon termination of the estate or trust. However, section 642(h) does not apply to a bankruptcy estate. Mueller v. Commissioner, 60 T.C. 36 (1973), aff'd. on this issue, 496 F.2d 899 (5th Cir. 1974); Richardson v. United States, supra. Moreover, 642(h) allows only a carryforward from a trust to the beneficiaries, and not from the grantor to the trust. See O.M. 19322, [redacted], I-190-80 (September 17, 1980).

Finally, we note that the [redacted] net operating loss carryovers are not property which passed to the [redacted] Trust upon Plan confirmation. The net operating losses are not property within the meaning of Segal v. Rochelle, 382 U.S. 375 (1966). See G.C.M. 35656, [redacted], I-110-73 (Feburary 5, 1974), July 19, 1976); O.M. 16196, Substantive Tax Problems Arising in Bankruptcy, I-2232 (September 10, 1968). Therefore, we conclude that the [redacted] Trust may not avail itself of the net operating loss carryovers of [redacted].

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